

improper use of the general allocator. The report also found that certain services provided by SBC to SWBT were improperly charged at a prevailing company rate that did not reflect actual costs. The Commission accordingly issued an Order to Show Cause why SWBT should not be found to have violated the affiliate transaction and cost allocation rules and appropriate enforcement action taken.^{26/}

Subsequently, the Commission entered into a Consent Decree settling issues arising out of a joint federal-state audit of the transactions between the Ameritech Operating Companies (AOCs) and their affiliate, Ameritech Services, Inc. (ASI). The Joint Audit Report concluded that ASI failed to provide adequate documentation to support the assignment of many costs to the AOCs and other affiliates. The Report also alleged that certain misclassifications of costs by ASI resulted in overallocation of costs to regulated ratepayers. Under the Consent Decree, ASI agreed to make certain changes in its accounting practices and payments to the United States Treasury and to the states of Ohio and Wisconsin.^{27/}

Furthermore, the cost allocation and other accounting rules are only as good as the Commission's willingness and ability to

^{26/} Southwestern Bell Telephone Co., AAD 95-32, FCC 95-31 (released March 3, 1995) (SWB Audit).

^{27/} Consent Decree Order, Ameritech, AAD 95-75, FCC 95-223 (released June 23, 1995) (Ameritech Consent Order).

enforce them with sufficient penalties to inhibit future misallocations. That final link in the chain may be the weakest of all. Most recently, the Commission released a summary of its audit of the BOCs' accounting for lobbying costs, which found \$116.5 million in misclassified lobbying costs during the period from 1988 through 1991.^{28/} Moreover, the inflated access rates resulting from such misallocations were carried over into the LECs' access rates under price cap regulation. In spite of these egregious violations, the Commission failed to take any remedial action for the past ratepayer injuries resulting from these misallocations.^{29/} The Commission's failure to take such remedial action confirms the inadequacy of the entire cost accounting regulation and audit function, since the LECs apparently have a "free shot" at any accounting violation they may wish to commit, knowing that the worst that can happen is that someday, if they are caught, they might have to correct such practices only on a going-forward basis.

The cost misallocations, excessive costs and cross-subsidies uncovered by these audits, and the Commission's limp response thereto, thus demonstrate the ineffectiveness of the cost allocation regulations in preventing LEC cross-subsidies between regulated and unregulated services. Since LEC monopoly and

^{28/} Commission Releases Summary of Lobbying Costs Audit Findings, Report No. CC 95-65 (released Oct. 26, 1995).

^{29/} See id.

regulated competitive services are more similar to one another than LEC regulated and unregulated services, allocations of costs between monopoly and competitive regulated services are more difficult to audit. Thus, the cost allocation rules, having failed at their primary mission, cannot possibly be relied upon to prevent cross-subsidies between LEC monopoly and regulated competitive services.

That price cap regulation has not dampened the incentive to misallocate costs is shown by the continuation of such behavior under price cap regulation.^{30/} Price caps have not, and cannot, remove the incentives and ability to cross-subsidize, since LECs may choose to be subject to sharing each year, which generates incentives to shift costs. The failure of cost allocation and other accounting regulations and price caps to stem such behavior reinforces the need for a separate affiliate for SNET's interexchange services.

SNET also argues that its bottleneck power has loosened on account of the equal access requirements. The MFJ's equal access requirements, however, were never considered to have altered the BOCs' bottleneck control and resulting dominance -- and thus the need for separation between their local exchange operations and

^{30/} See, e.g., SNE Audit, *supra*, at ¶ 2 (audit covered 1989 through 1992); Ameritech Consent Order, *supra*, Concurring Statement of Commissioner Andrew C. Barrett (audit covered transactions in 1992).

their competitive services³¹ -- and SNET has not explained why equal access should make any more of a difference in the case of its interexchange services.

2. The DPUC's Regulatory Policies Have Not Significantly Loosened SNET's Local Bottleneck Power

SNET also points to the DPUC's authorizations of five local exchange and access competitors, as well as this Commission's Expanded Interconnection rules, in support of its claim of nondominance. In fact, however, to MCI's knowledge, all of the competitors that have been authorized to date have a total of just one customer among them. One of the five competitors, MCI Metro -- MCI's local exchange service affiliate -- only just filed its local exchange and intrastate service tariff and has no customers. There is, therefore, not yet any local competition to speak of in SNET's service area. Just how distant significant local competition really is can be seen from the vast disparity between SNET's 143 central offices, as of the end of 1994,³² and the grand total of one switch that has been installed to date by all of SNET's competitors combined.

³¹ Compare Fifth Report, 98 FCC 2d at 1198, n.23 (need for separate BOC interexchange subsidiary), with BOC Separation Decision, cited therein (Policy and Rules Concerning the Furnishing of Customer Premises Equipment, Enhanced Services and Cellular Communications Services by the Bell Operating Cos., 95 FCC 2d 1117, 1132-36 (1983) (prior order discussing implications of MFJ equal access requirements for BOCs), aff'd sub nom. Illinois Bell Tel. Co. v. FCC, 740 F.2d 465 (7th Cir. 1984)).

³² FCC Industry Analysis Division, Trends in Telephone Service at Table 13 (February 1995).

SNET discusses the DPUC's requirements of intrastate toll dialing parity and two-carrier presubscription as additional pro-competitive steps that have reduced its dominance. Those are positive steps, but they have only an indirect effect on SNET's ability to leverage its local exchange dominance in the interstate interexchange market, which is the subject of this proceeding. SNET is deprived of a regulatory advantage by these reforms, but it still has the ability and incentive to discriminate against interstate interexchange competitors in ways that are not authorized.

The fragility of the tentative moves toward local competition taken by the DPUC is illustrated by the manner in which SNET has carried out, or failed to carry out, the DPUC local exchange unbundling, resale and interconnection requirements. SNET asserts that it has filed the required tariff for its unbundled local service elements and wholesale local service and that "the DPUC has issued a final decision accepting its tariff with modifications."^{33/} Not quite. In fact, the DPUC Decision cited by SNET found that it "has proposed to price its unbundled service elements and wholesale local service offering at rates that in most instances are higher than current retail rates," and that SNET's failure to provide a proper justification for its rates has "jeopardized the evolution of broader market participation in Connecticut and the realization of competitive

^{33/} SNET Pet. at 22.

benefits by the public."^{34/}

Accordingly, while the DPUC technically allowed the proposed tariffs into effect, so as not to deprive competitors of the benefits of unbundling, it required substantial reductions in a wide range of the proposed rates on an interim basis until SNET files "an acceptable set of costs and proposals"^{35/} -- e.g., a 50% reduction in nonrecurring charges for unbundled ports, unbundled loops and interwire center transport; reductions of 35% to 48% in residential and business wholesale local service recurring charges;^{36/} and reductions of 15% to 33% in unbundled local loop recurring charges.^{37/} SNET has not yet refiled an acceptable tariff.

Similarly, SNET's proposed interconnection tariff, which is still under review, charges excessive rates and fails to implement the DPUC interconnection requirements order cited by SNET in other ways as well,^{38/} thereby nullifying whatever pro-

^{34/} Decision, Application of the Southern New England Telephone Company for Approval to Offer Unbundled Loops, Ports and Associated Interconnection Arrangements, Docket No. 95-06-17 (DPUC Dec. 20, 1995), at 80-81.

^{35/} Id. at 84.

^{36/} See id. at 83.

^{37/} See id. at 84.

^{38/} SNET Pet. at 23, n.56, citing Decision, DPUC Investigation Into the Unbundling of the Southern New England Telephone Company's Local Telecommunications Network, Docket No. 94-10-02 (DPUC, Sept. 22, 1995), recon., Decision (DPUC, Jan. 17, 1996).

competitive effect such interconnection hypothetically might have generated. Among the defects discussed by MFS in its comments to the DPUC on SNET's interconnection tariff are the following: SNET's proposed rates for local number portability are way above rates for comparable services charged by other LECs; it imposes a high fee for NXX administration, which is free in many other states; and SNET fails to offer such required features as operator services, two-way trunking and meet point billing provisions, at any price.^{39/}

Since the competitive impact of local service unbundling, resale and interconnection depend largely on the rates to be charged therefor, SNET's apparent reluctance to charge reasonable rates for such services or even to offer some required interconnection features, undermines any claim that these regulatory initiatives have led to competitive local service and access markets. Once reasonable rates have been filed and potential competition becomes actual competition, SNET's request may become more realistic.

SNET mentions the DPUC's price cap regulation as another factor reducing its ability to leverage its market power, but it never provides any logical connection between price cap

^{39/} Comments of MFS Intelenet of Connecticut, Inc. at 4-6, 8-9, Application of Southern New England Telephone Company for Approval to Offer Interconnection Services and Other Related Items Associated with the Company's Local Exchange Access Tariff, Docket No. 95-11-08 (DPUC, Jan. 16, 1996).

regulation and reduced market power. SNET may be trying to argue that intrastate price cap regulation reduces its incentive to cross-subsidize, but that simply repeats its argument about this Commission's interstate price cap regulation, which has already been addressed in Part II (B)(1), supra. There is no reason to expect that intrastate price cap regulation will be any more successful than this Commission's price cap regulation in suppressing cross-subsidization.

The irrelevance of all of the factors mentioned by SNET, and its continuing local bottleneck power, are confirmed by its "excess" intrastate earnings, as found in the DPUC's recent Draft Decision in the SNET Alternative Regulation proceeding.^{40/} SNET would not be able to achieve "excess" earnings if it no longer had local bottleneck power. This one statistic trumps all of its arguments, and they therefore may be ignored. Reinforcing this conclusion is SNET's failure to seek reclassification for its intrastate switched access service as competitive or emerging competitive.^{41/} SNET could hardly have overlooked such a procedural possibility. The only conclusion that can be drawn is

^{40/} Application of the Southern New England Telephone Company for Financial Review and Proposed Framework for Alternative Regulation, Docket No. 95-03-01 (DPUC Jan. 9, 1996), Draft Decision at 135-37 (referring to "Current Excess Earnings").

^{41/} See Initial Brief of MCI Telecommunications Corporation at 8-9 (citing SNET pleadings), Application of the Southern New England Telephone Company for Financial Review and Proposed Framework for Alternative Regulation, PHASE II, Docket No. 95-03-01 (DPUC Jan. 31, 1996).

that not even SNET regards intrastate switched access service in its service territory as competitive.

Almost as an afterthought, SNET casually asserts that even apart from the developments that have supposedly reduced its local bottleneck power and market leverage, "market realities" remove any incentive to exercise that leverage in the interexchange market. It argues that since the interexchange market is a single, nationwide market, its ability to exert its local exchange bottleneck power in that market is nullified by the small volume of access services it provides, relative to the total access services provided by LECs nationwide. There are two problems with that argument: SNET is not as small as it claims, and its size is irrelevant.

As pointed out in the introductory discussion, SNET serves a significant market, by any measure. Even a nationwide IXC would be adversely affected by SNET's discrimination or cross-subsidization. Any IXC wanting to offer nationwide service cannot ignore such an important market as Connecticut. Moreover, it must be kept in mind that there is not a nationwide local exchange or access market, in which different LECs compete with one another. Within SNET's service area, it has nearly 100% of the local exchange and access markets, since it has virtually no actual competition yet. The fact that it provides a small volume of access services compared to a BOC that does not compete with

it is meaningless. Its near 100% control of all local and access services in its territory gives it powerful leverage in the interexchange market as to calls originating or terminating in Connecticut, a hefty enough segment to make it worthwhile for SNET to try to exercise its considerable leverage. The Commission was aware at the time of the Competitive Carrier proceeding that many LECs were quite small, but that did not affect the separate affiliate requirement then, and SNET has not shown why its size should become a determinative factor now.

As for SNET's small interexchange market share and the existence of well-established interexchange competitors, those also were not important factors in Competitive Carrier, and they should not be considered important now. The Commission found the LECs dominant in their unseparated offering of interexchange services in spite of their low interstate interexchange market shares.^{42/} That is still true.

Finally, SNET's behavior demonstrates that it still has both the ability and the incentive to discriminate against competitors. As pointed out above, SNET has only grudgingly carried out the DPUC's competition policies and has offered competitors the services required by those policies at

^{42/} Compare Fourth Report, 95 FCC 2d at 575 & n.69 (low LEC affiliate interexchange market shares), with Fifth Report, 98 FCC 2d at 1198 (need for separation of LEC interexchange operations from its local exchange network).

unreasonable rates. The wide range of discriminatory techniques at SNET's disposal is also shown by SNET's recent abysmal service provisioning performance (at least with regard to access services ordered by MCI). Whether or not SNET's unacceptable access service provisioning performance has been motivated by its own offering of interexchange service, that performance, together with SNET's foot-dragging in carrying out DPUC competitive requirements, disprove its notion that it has no anticompetitive incentives. Thus, none of the factors proffered by SNET alters the original analysis in Competitive Carrier or provides any support for its claim of nondominance for unseparated interexchange services.

C. The Need for a Strict Imputation Requirement
Precludes Nondominant Status

Even apart from the continuing validity of the Competitive Carrier rationale for separate LEC interexchange affiliates, there is another obstacle to nondominant treatment for unseparated LEC within-region interexchange services. The Commission has a long-established policy of requiring the uniform, nationwide application of all switched access charges to the origination and termination of all carriers', including all LECs', interexchange services.^{43/} The Commission's imputation policy "promote[s] full and fair competition in [interexchange]

^{43/} Application of Access Charges to the Origination and Termination of Interstate, IntraLATA Services and Corridor Services, FCC 85-172 (released April 12, 1985).

markets by ensuring that all carriers [including LECs], when acting as [IXCs], will pay full access charges for...[interexchange] services."^{44/} In other words, imputation is intended to prevent LECs from subjecting their competitors to a price squeeze by ensuring that their interexchange rates cover their own access charges.^{45/}

Of course, it has become apparent that imputation, by itself, does not begin to put LECs and IXCs on a level playing field in interexchange markets, since LEC access rates are still way above costs.^{46/} Excessive access rates allow LECs to extract huge profits from their captive ratebase, the IXCs, while simultaneously keeping the IXCs' costs at an excessive level,

^{44/} Id. at ¶ 11. When the Commission announced this rule, it only applied to LEC corridor and interstate intraLATA services, since those were the only interexchange services the LECs were providing at that time. The same principle, of course, would apply to all LEC interexchange services.

^{45/} Cf. Local Exchange Carriers' Rates, Terms and Conditions for Expanded Interconnection Through Virtual Collocation for Special Access and Switched Transport, CC Docket No. 94-97, Phase I, FCC 95-200 (released May 11, 1995), at ¶ 71 (excessive interconnection charges expose competitive access providers to "price squeeze"), pet. for review filed sub nom. Southwestern Bell Telephone Co. v. FCC, No. 95-1351 (D.C. Cir. filed July 13, 1995).

^{46/} Nationwide, local service charges recover all but about \$4 billion of the economic costs of providing local loop and switching services. Meanwhile, interstate carrier common line and local switching charges total about \$6.7 billion nationwide, and total intrastate access charges, which consist largely of loop and switching charges, add another \$7.1 billion, for total loop and switching access charges equalling about three times the unrecovered economic cost of providing loop and switching. See MCI Comments at 5 & n.8, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1 (filed Dec. 11, 1995).

thereby giving the LECs a tremendous competitive advantage. Strict imputation rules, however, at least preclude an even greater advantage for the LECs.

In order to implement the Commission's imputation rule, it would have to be possible for the Commission to compare all LEC interexchange rates with the costs of those services, on a service-by-service basis. That, in turn, would require that a LEC file cost support with any interexchange tariff filing to permit the analysis necessary to determine compliance with the imputation requirement. Accordingly, every LEC interexchange tariff filing, whether for SNET's services or otherwise, must include a description of the access services required to provide each interexchange service and the methods and assumptions used in the calculation of the imputation test for each such service, as well as a showing that the calculation was performed in a proper manner.

Thus, in no event could SNET file interexchange tariffs on one day's notice, since that would not allow sufficient time for the Commission to fulfill its statutory requirements under Section 201 of the Communications Act. The analysis required by the imputation rule therefore would effectively preclude complete nondominant status for SNET or any other LEC in-region interexchange service.

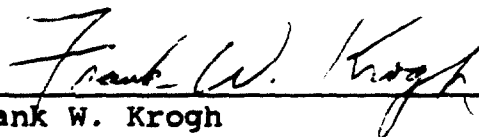
CONCLUSION

For the reasons explained above, the Commission should defer any review of, or action on, SNET's Petition until the Commission concludes its review of the Competitive Carrier criteria, the BOC Out-of-Region proceeding and any general LEC forbearance proceeding under the new legislation. If, however, the Commission were to address the Petition on the merits, it would have to be denied on account of SNET's continuing local bottleneck control and incentive to use that power in an anticompetitive manner.

Respectfully submitted,

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Dated: February 26, 1996

***Long Distance:
Public Benefits From Increased
Competition***

Robert E. Hall

October 1993

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LONG DISTANCE: PUBLIC BENEFITS FROM INCREASED COMPETITION

Updated May 1995
Robert E. Hall
Applied Economic Partners

Long distance prices continue to fall. The most recent data show that real prices for long distance calling declined by 14 percent in the last three years, with a 5% decline in 1994 alone. Since divestiture, long distance prices have declined by 67% in real dollars.

These updated numbers reflect the latest available data from the Federal Communications Commission. In addition, the relationship of revenues, access charges, and revenues net of access charges has been calculated using domestic billed revenues and minutes based on proprietary data provided by AT&T, MCI, and Sprint for 1991-1994.

We also updated the analysis to determine whether the decline in long distance prices exceeded the decline in access charges. As in previous years, data since 1991 shows that long distance prices continue to decline more than access charges. The data show that less than 40% of the decline is attributable to the decline in access charges. Moreover, since divestiture, revenue per minute has declined 33 cents while access charges per minute have declined only 13 cents.

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Consumers Pay Less For Long Distance In Competitive Market, New Data Says

WASHINGTON -- The prices American families and businesses pay for each minute of long distance calling has continued to decrease steadily since the breakup of the Bell System in 1984, according to new data released today by Professor Robert Hall of Stanford University. The data show that real prices for long distance calls declined by 14 percent in the last three years, with a 5% decline in 1994 alone.

Dr. Hall's data show that enormous consumer savings have occurred in the competitive long distance telephone marketplace. Since 1985 the amount that American consumers pay for a minute of long distance calling has declined by 67 percent in real dollars. The new data show that the same call that cost \$1.00 in 1991, measured in today's dollars, would cost 86 cents today. That decline means lower long distance bills for consumers.

"Since the breakup of the Bell System by court order in 1984, the long distance telephone industry has mushroomed to more than 500 companies across the country. Dr. Hall's analysis provides evidence of continued, robust competition in the long distance market," explained Senator Howard H. Baker, Jr., Chairman of the Competitive Long Distance Coalition.

As Congress considers new legislation governing the telecommunications industry, competition in the long distance telephone markets has provided a ledger for scoring greater service at less cost.

Dr. Hall's analysis is based on the actual prices paid by customers of the three largest long distance companies for telephone service during the 1991-1994 period. These data reflect whatever discount plans may have been in effect at the time. These data, based on actual experience, show that the price indices prepared by the U.S. Bureau of Labor Statistics understate the decline in long distance prices because they fail to include the discounting plans. This new study measures price declines from average revenue per minute, which is what the customer pays on average for a minute of long distance services.

The government measurements in the past have been based on a single tariff or subset of tariff changes which do not reflect total price declines.

-- more --

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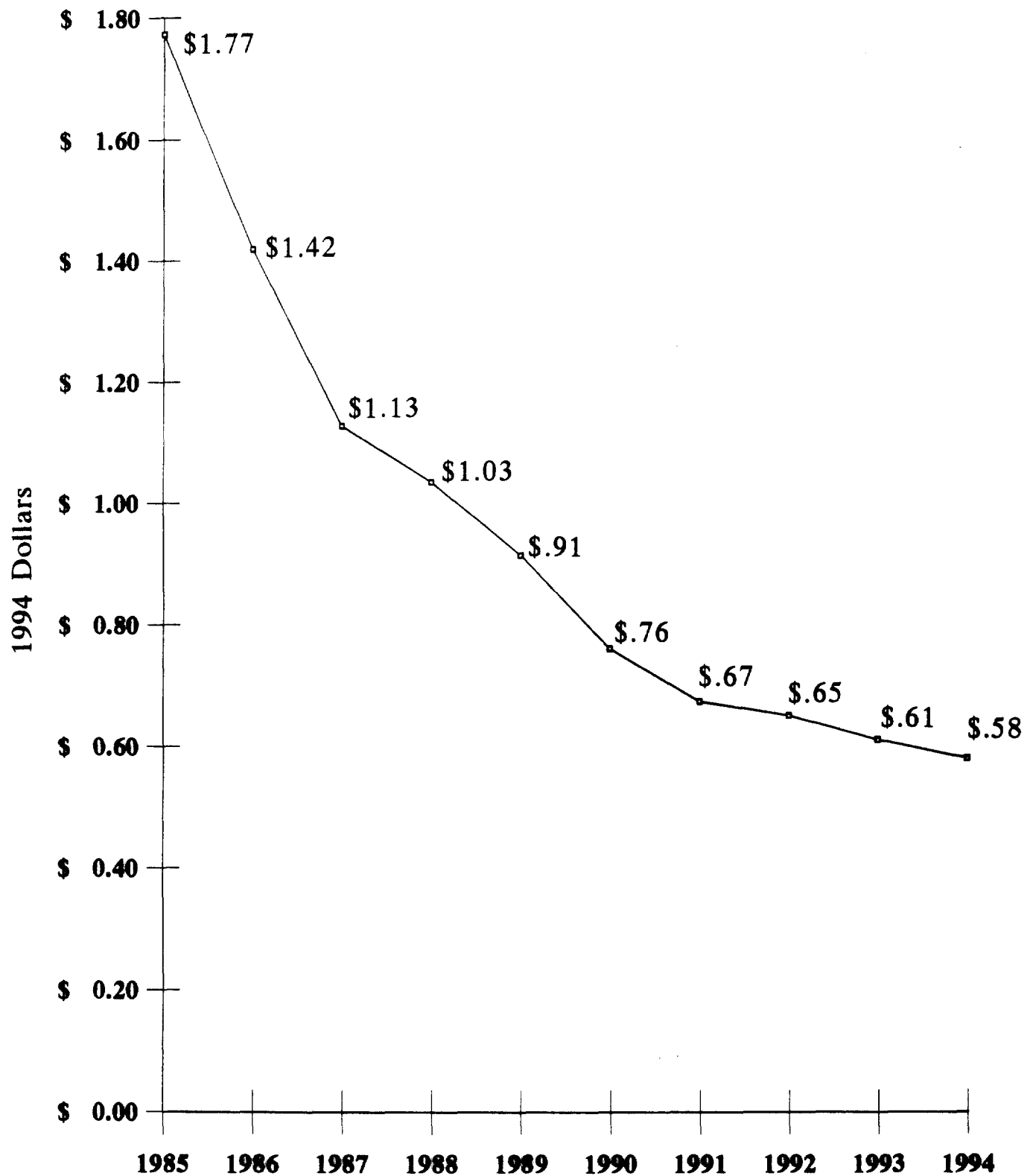
"Today, no customer is captive to a long distance carrier. If one carrier provides poor service or overprices its product, the customer can easily switch to another carrier," according to Dr. Hall.

One of the factors accounting for the decline in long distance prices is the reduction in access charges. Access charges are imposed by the local telephone companies on long distance carriers for access to the local network. The monopoly local telephone companies, whose combined annual revenue for 1994 exceeded \$90 billion, collected more than \$26 billion from the long distance companies in access charges. These charges far exceed what it costs the local telephone companies to provide access and universal service.

But the decline in long distance prices continues to exceed the decline in access charges. In the last three years, access charges account for less than one-half of the reduction in long distance prices. Competition in the long distance marketplace is the key that has opened major cost savings in long distance prices for the American consumer.

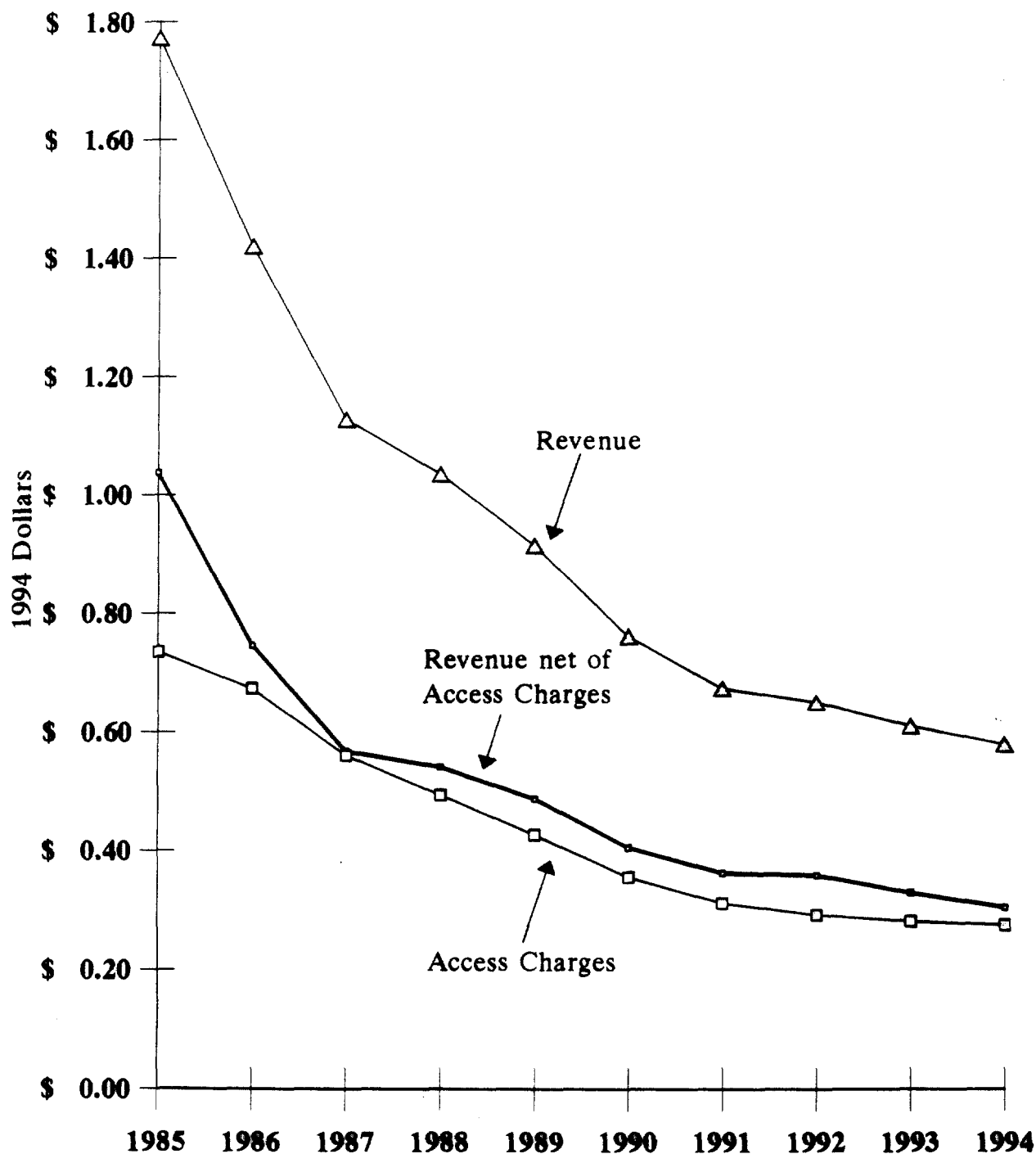
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The Cost of an Average Long Distance Call



Source: Robert E. Hall, Long Distance: Public Benefits From Increased Competition, 1995 Update.

Revenue and Access Charges for an Average Long Distance Call for the Three Largest Carriers



Source: Robert E. Hall, Long Distance: Public Benefits From Increased Competition, 1995 Update.

***Long Distance:
Public Benefits from Increased
Competition***

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October 1993

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Executive Summary

Important structural changes have taken place in the long-distance industry in the last two decades. The industry has moved from a tightly regulated monopoly to active competition among a number of rival firms.

Key steps in the transition were:

- The establishment of the legal right to compete with AT&T,
- The structural separation of local and long distance accomplished by divestiture of the Bell System in 1984, and
- The requirement of equal access by local telephone subscribers to alternative long-distance providers.

Economic analysis predicts that enhanced competition will drive prices down to a new, lower level. Lower prices are a primary way that the public benefits from pro-competitive policies. After the transition to lower prices, competition delivers continuing low prices. These predictions aptly describe actual events in long distance:

- Between 1985 and 1988, according to government price indices, the price of long distance relative to the general price level fell by 30 percent.
- Between 1988 and 1992, the price fell by about another 17 percent.
- The average revenue per minute earned by the three largest carriers fell 63 percent relative to the general price level from 1985 to 1992.
- Net of access charges paid to local telephone companies, the revenue per minute of the three largest long-distance carriers fell by 66 percent between 1985 and 1992 after adjustment for inflation.

- Since 1989, AT&T's price for regular long-distance calls has fallen by three percent per year net of access charges, after adjustment for inflation.

The transition to competition has also seen a remarkable growth in the quality, variety, and technical capabilities of long-distance services:

- Reductions in noise, cross-talk, echoes, and dropped calls have made the usefulness of one minute of telephone conversation rise at the same time that the price of that minute has fallen.
- Fiber optics now carry the bulk of long-distance traffic, at lower cost and higher quality than the earlier microwave technology. The transmission speed of state-of-the-art fiber has doubled every three or four years since fiber was introduced.
- Long-distance carriers have led the way in digital switching and common channel signaling.
- The long-distance industry has developed software methods for providing efficient private network services for large businesses, using common physical facilities.
- The industry has created innovative new types of long-distance service to improve the efficiency of communication for consumers and businesses, large and small.

Competition has worked in long distance because the nature of the product and the technology for producing it are suited to competition and because regulation has fostered conditions conducive to competition:

- The success of equal access has shown that it is practical and effective to give every telephone user free choice among long-distance carriers.
- No customer is a captive of a long-distance carrier. If one carrier provides poor service or overprices its product, the customer can easily switch to another carrier.
- There are no artificial barriers to entry in long distance. Although it would be expensive to reproduce an entire national network of the type operated by AT&T, MCI, and Sprint, that investment would

pay off if there were much overpricing of service by those national carriers. Moreover, effective entry could occur without construction of any new networks, by leasing capacity from owners of subnational fiber networks and by reselling services from other carriers.

An important part of the evidence that competition has worked in the long-distance market is the lack of monopoly profits among the carriers. The return on assets by the three largest carriers recently has been *below* the rate of return allowed by regulators for local telephone service.

Proposals have been made to lift the line-of-business restriction and thus permit the Regional Bell Operating Companies (RBOCs) to control long distance carriers. That move would be harmful to long-distance customers because:

- The principle of separate ownership of local and long-distance service is sound as a matter of economics; it is the most effective way to ensure reliable, efficient long-distance service and to give customers a free choice among long-distance carriers.
- RBOC entry would not increase the number of long-distance carriers in the long run.
- Experience has shown that regulators cannot prevent all the methods that a local carrier can use to reduce the efficiency of its rivals and to divert business to its own competitive service, when that service is dependent on the local telephone network. This danger is particularly important for long distance.
- Regulation also cannot guarantee that costs for a competitive business, such as long distance, are not reported as costs of a related regulated monopoly business, such as local service.

Overall conclusions from this review of the structure and performance of the contemporary long-distance industry are:

- The active competition made possible by divestiture in 1984 rapidly drove prices downward.